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CURRENCIES AND CREDIT MARKETS

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Economists and all forecasters tend to be wrong the most at exactly the time they are needed most - at inflection points. It is human nature to believe that a trend in motion will continue in motion. But forecasting a change in direction leaves the forecaster the most exposed, and subject to ridicule if wrong - another reason to stay with the pack so that all will be right or wrong, together.

R.F. deVoe of Legg Mason Wood & Walker
Journal, July 5, 1988.

HIGHLIGHTS

Exchange markets are being swayed by one single but erroneous idea: interest-rate differentials. Nothing else counts, not even stalling trade adjustments, weak economic growth or inflation.

It's the inevitable outcome of a mix of national policies which grossly perverts the whole exchange rate system casting hard currenices down and driving weak currencies up.

All this, including the prevailing euphoria, looks strangely like 1987 all over again. But there are important differences and none of them is reason for jubilation.

Considering current inflation, interest rate levels and the huge current account deficit, it seems to us that the U.S. economy is within grip of a liquidity squeeze.

Recent third and fourth quarter economic data fully confirms our view that the U.S. economy is already in the midst of a sharp slowdown. A severe recession is becoming a major risk.

Hopes are riding high that deficit countries will be able to engineer a "soft-landing" both in their economies and their currencies. The puzzle is how all countries can enjoy an export boom when all are restraining domestic demand.

In one respect, the questions are now fewer. No longer is it a matter of whether and when the U.S economy will begin to slump. The major question is when capital markets will awaken and revise their perception of economic robustness.

As always, the timing is uncertain but the ingredients for great trouble are undoubtedly looming into place. With present developments, the dollar will return to its long-term bear market with ferocious vigor.

MORE INSTABILITY ALL IN THE NAME OF CURRENCY STABILITY

Once again, exchange markets are being swayed by one single idea: interest-rate differentials. Nothing else counts. This simple-mindedness has now reached the wondrous point where the announcement of a large trade deficit is bullish for that country's currency. Higher inflation or deficits are gleefully interpreted as a precursor of tighter money and higher interest rates. The American junk bond craze has now found the international currency market.

Though the U.S. dollar is without question the ring leader within this rogue troupe of "high-yielding currencies", the smaller side-kicks, above all the Canadian and the Australian dollar, have performed even better. That has happened for two obvious reasons: first, because the inflation and balance-of-payments problems of these countries are even worse than those of the United States their central banks have been forced into even tougher action; and second, since these currencies have extremely narrow markets compared to the U.S. dollar and vast pools of international investment funds and hot money, small capital inflows have great leveraging effects on these currencies. In short, not much money is needed to move these currencies sharply.

While the central banks of these deficit countries repeatedly raise their interest rates to check excessive domestic demand, the central banks in Continental Europe in turn raise their interest rates to slow the offsetting decline of their currencies. As a result, all interest rates world-wide have been ratcheting up.

IT LOOKS LIKE 1987 ALL OVER AGAIN. BUT THERE ARE DIFFERENCES.

All this, including the prevailing euphoria, looks strangely like 1987. But there are three important differences and none of them reason for jubilation: first, inflation and interest rates are mostly higher today; second, most economies are weaker and more vulnerable. Earlier, though it had not been recognized at the time, economic activity was still forging ahead. That cannot be said now. And third, trade adjustment has generally stalled. Surpluses of Japan and Germany are again rising, while the deficit countries show soaring imports relative to sharply softening export growth. This, of course, is not accidental. It's the inevitable and predictable outcome of a mix of national monetary policies which grossly perverts the whole exchange rate system casting hard currencies down and driving weak currencies up. In the name of currency stabilization and trade co-ordination - the esteemed goals of the Louvre Accord - what instead has been wrought is further excesses and more instability.

Lessons Not Well Remembered. Just over a year ago, when many analysts saw ominous parallels between October 1987 and October 1929, the typical forecast was for an economic slump of sorts in 1988. Instead, the world economy accomplished a synchronized boom similar to the situation in 1972/1973. Then as now, the boom has

been associated with a price inflation in raw materials.

One would think that these experiences should have humbled forecasters and policy-makers teaching them the lesson of how little we sometimes even know about the recent past, not to mention the future. Exactly the opposite effect appears evident. Since the feared "hard-landing" has so far been fortuitously avoided they now have the temerity to exude that everything is in hand and that any set-back - no matter how bad - is containable.

THE U.S. ECONOMY WEAKENS BEFORE UNBELIEVING EYES

It is taken for gospel truth today that the U.S. economy is tremendously robust and almost irrepressible. Nobody dares spit into the wind. Everybody speaks of the longest economic upswing in the United States of the whole post-war period. Conveniently forgotten is that industrial production had been almost stagnant for more than two years between 1985 and early 1987. The memory again lapses when it comes to recognizing that it was an export boom, borne out of a massive dollar devaluation and exploding foreign demand that finally resurrected a recovery.

No Grounds for Complacency. Bearing in mind the near-depression that gripped the Rust Belt in 1985/86, there is absolutely no ground for complacency about the indefectible "robustness" of the U.S. economy. With its high debt levels, the economy continues to become more vulnerable than ever before. And, contrary to what the markets might want to believe, the mirage of economic invincibility is already disappearing into thin air. The GNP reports of the third and fourth quarters confirm deepening weakness, not continued strength. As we elaborated in our last letter, the unseen factor so far is the abrupt abortion of the recent export and capital spending boom. The emperor indeed may be naked. What growth there was during these recent quarters came from consumer and government spending.

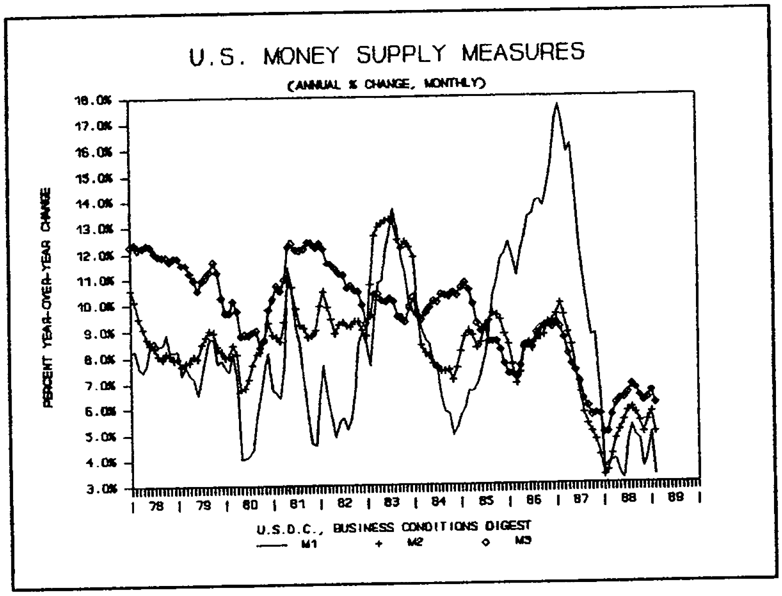
Two Key Sectors in Sharp Downturn. Recognizing that net exports and capital spending, which have accounted for 80% of GNP growth during the recent recovery have turned negative, is only one reason for our position that the U.S. economy is heading for a substantial weakening in the near future. There is another contributing factor: monetary policy. Most people seem to underestimate the monetary tightening that has been in tow, not only recently, but already since early 1987. Without exception, all monetary measures tell the same story.

MONETARY POLICY MAY YET BE THE SMOKING GUN

As most know, a process of monetary expansion or tightness starts with changes in bank reserves. When the Fed adds to bank reserves, it sets into motion a process that expands credit and money supply. In reverse, when a central bank restrains growth in non-borrowed bank reserves, credit and money growth slows. From June 1982 to the end of 1986, Fed bank reserves rose from $42 to $71 Billion, an

increase of almost 70% representing an average of 18% per year. Since the first quarter of 1987, however, the big spurt in bank reserves has stopped. Over the past two years, total reserves have increased at only a 2% annual rate.

All Monetary Measures Show Tightness. Precisely the same spectre of severe monetary restraint emerges when one looks at the different measures of money supply. Comparing year-over-year, real M2 peaked in January 1987 at $2,450 billion after having risen in 1986 by $90 billion, or 8%. Ever since, real M2 growth has stagnated at this level. The same sequence of events holds for real M1, following a surge in 1986 of 15%.



Looking at the different money supply aggregates this way, U.S. monetary policy thus appears uneqivocably and extremely tight. Yet, if one looks at the current credit expansion, running stubbornly between an annual rate of 8 - 9%, it seems widely generous. Are not banking billions readily available to fund mega-mergers?

Credit: High Growth May Still Not Be Adequate. But, is credit growth in that range too little or too much? It depends on the circumstances. In the case of Germany with low inflation, low interest rates and a huge external surplus swamping the domestic economy with liquidity earned from exports, credit expansion at that pace would surely be excessive. Actually, Germany's domestic credit has recently been growing at an annual rate of about 5%. Under the given conditions for Germany, even 5% is pretty high.

The U.S. economy, though, is a very different case. It needs a lot more credit just to keep afloat. There are two important reasons why: first, considerably higher inflation and second; higher interest rates combined with the recent sharp rise in debt levels. A high debt service burden raises credit requirements if corporations and private households wish to maintain their spending on goods and services.

Current Account Deficits Make the Difference in Liquidity. But there is still a third cause that augments the credit requirement of the U.S. economy. And that is the huge current-account deficit which subjects the economy to a persistent and massive liquidity drain. The point to see here is that such a deficit concurrently withdraws money from internal circulation by an equivalent amount.

As cash balances are transferred to foreigners, domestic money supply is depleted and therefore is no longer available to buy current goods and services. The foreigners, on the other hand, with their burgeoning coffers of dollars buy existing U.S. financial and real assets. But the key to notice here is that little of this recycled money returns to current output thus causing a divergence in price inflation and asset price inflation.

The Wealth Wedge. A current account deficit always has its counterpart within the financial system of a respective country. The corresponding transfer of domestic financial and real assets drives a wedge between debt growth and both domestic wealth and money creation. The following table, covering the period from 1975 to 1988 and true to script, provides evidence of how the "foreign drain" has already impacted the U.S. economy.

We observe that the phase of large external deficits for the U.S. started in 1984. In that year, however, the "foreign drain" on the growth of U.S. private financial wealth was largely offset by the positive wealth effects of a surging budget deficit and rising asset prices. Since that point, the "wedge" is more clearly evident.

By contrast, when the U.S. current account was still in much better balance between 1975 and 1983, a much better balance between debt and wealth growth existed as the table above shows. As opposed to today, American investors at that time bought foreign assets to a large extent.

A Severe Liquidity Squeeze Appears in the Offing. To draw our conclusion: considering current inflation and interest rate levels and the huge current account deficit, it seems to us that the U.S. economy is within grip of a severe liquidity squeeze. And as clearly reflected in the weak monetary aggregates this tightening already started in early 1987.

TABLE 1
GROWTH OF DEBT AND PRIVATE FINANCIAL ASSETS, U.S.
(Annual % change)

	DEBT	PRIVATE FIN. ASSETS -ABROAD-	-AT HOME-
1975	9.0	17.4	9.4
1976	10.7	21.5	10.9
1977	12.6	11.7	11.0
1978	13.2	18.6	11.5
1979	12.1	9.5	11.7
1980	9.6	14.0	9.6
1981	9.5	12.0	10.6
1982	9.1	7.3	10.3
1983	11.7	8.3	11.6
1984	14.4	3.7	13.6
1985	14.2	0.5	12.2
1986	12.2	4.1	8.0
1987	8.9	1.8	6.6
1988	8.8	3.0	6.5

Source: Federal Reserve, Flow of Funds Accounts

But if money has become so tight, why has it failed to restrain the

U.S. economy which, instead, took off into a strong recovery even shrugging off both debilitating effects of a stock market crash and a drought? That apparent defiance of so many obstacles has led most people to conclude that money supply apparently doesn't matter anymore. Hence, money supply figures no longer make the statistic of the month club.

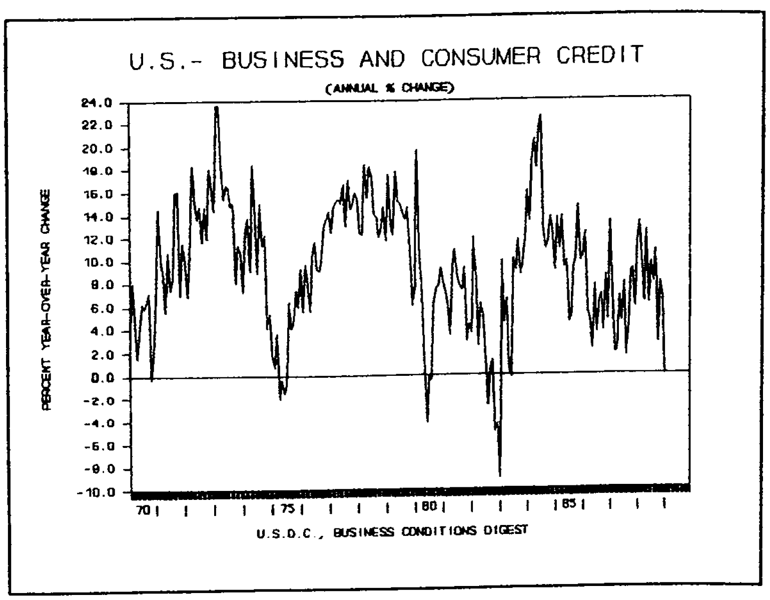
What is overlooked here is that the recent strong recovery got its big stimulus from rapidly accelerating money growth abroad, including Japan, Germany, Europe and elsewhere, and in that way fueled the U.S. export and investment boom. Under those conditions of a soaring world money supply, the U.S. economy could stage a strong recovery despite tight money at home. Yet, it did change the composition of U.S. output in the direction of export and capital spending as surging exports boosted business profits.

THE "STOP-AND-GO" IS STILL WITH US

To add a historical perspective to these observations, we recommend a look at the following chart. It shows credit growth in the United States since 1970. During this time there were three major upward moves. Each led to a boom, while every major decline brought on a recession.

In the early 1970's, U.S. credit growth entered the double-digit range for the first time. After reaching a peak expansion rate of 12.3% in 1973, credit growth then fell back to 8.3% causing a severe recession. From 1978 through 1982, there was a drop from 13.3% to 9.1% resulting in the worst recession in the post-war period. The latest drop - from over 14% in 1984/85 to 8.5% in 1988 - is the sharpest ever. To us, quite frankly, the extreme up and down of the U.S. credit curve continues to have the familiar look of "stop-and-go".

THE MISTAKES IN CURRENT MONETARY POLICY: ONE BEGETS ANOTHER.



As we begin this critical year, we note a widespread belief that any future slowdown in economic growth can and will be contained before it reaches the state of an actual recession. More and more, the financial press is refecting the idea that recessions are only possible if central banks make serious blunders in their management of money and credit - but that such errors are neither in sight nor likely,

given the high levels of expertise that the major central banks have demonstrated in recent years.

The hubris involved in this kind of thinking should be obvious - but it obviously isn't. In his book about the Federal Reserve, "Secrets of the Temple", William Greider describes how Paul Volker and other Fed veterans were haunted by the question: At what point during the previous business cycles did the central bank make its big mistake? At the beginning by being too accommodative too long or at the end by being too tight too long?

Prior Over-Stimulation is Clearly Evident. We would say central banks generally make both mistakes because the first one implies the second. And in classic form, that sequence is precisely what we're seeing in some countries today. What is it that has forced Mr. Nigel Lawson to jack up British short-term interest rate to a murderous 13%? What about Australia's recent push to an unconscionable interest rate of 16%? In Mr. Lawson's case, it was necessary because he first foolishly lowered them earlier last year to 7.5%, thus over-stimulating the economy. Australia's Mr. Paul Keating appear to have been guilty of the same over-indulgence. In our opinion, the mere fact that so many countries must now resort to high double-digit interest rates is proof enough of prior overstimulation... in other words of the first grave policy mistake.

All these countries with excess domestic demand, huge current-account deficits and relatively high inflation rates - including the United States, Britain, Canada, Australia and some others -are altogether guilty of one and the same mistake: that of having overstimulated their economies. With the first mistake already in evidence how long will it be before the second one casts its shadow?

Nevertheless, so we are assured, a return to the bad old days is not pre-destined. Actually, gigantic deficits and high interest rates are really the signs of economic dynamism and herculean health, not monetary misadventure and fiscal excess. The only thing new to us in all of this is that so many people want to believe this nonsense. This "new wave" soothsaying has created an unprecedented tolerance for policy excesses, and as a result, a world economy that is imbalanced as never before.

Now Comes the Belated Recognition. After realizing that their past policies have been too loose and fancy-free, all these countries gorged on inflation and deficits are now determined to correct this blunder by staying on the monetary brake until they see clear evidence of declining inflation. Considering how late they discovered the signs of last year's boom, one can only wonder how timely they will be in discovering the downturn.

ACCELERATING INFLATION PHENOMENON

The trouble with this kind of policy is that in the final phase when the boom peaks, inflation tends to get yet another kick on the upside as slower productivity growth places additional upward pressure on unit labor costs. In fact, that's precisely what has already begun to happen in the United States. During the second and third quarter of 1988, unit labour costs accelerated to a 6.6% rate of increase, reflecting growth in hourly wages at a 5.4% rate and a decline in productivity of 1.1%. The latter slowed sharply following a prior productivity gain of 2.1%.

We don't quite see how all this differs from the ill-fated "stop-and-go" policies of the past. To us, it even seems that policy swings from overstimulation to over-tightening are actually worse than ever in some countries. Ironically, all of these interlopers rely on the same recipe for a soft landing. The lower domestic demand which they desire, is not supposed to bring output growth to a grinding halt. Instead, producers are expected to respond to weaker home demand by switching towards exports. The puzzle is how all countries can enjoy an export boom when all are restraining domestic demand.

MONETARY POLICY ON THE INTERNATIONAL STAGE

The two main questions that must be answered at this point are: first, how quickly and how strongly will the worldwide tightening in money that's been in place since the second quarter of last year impact the different economies? Second; which economies are the most prone to overkill and a downturn?

Several Countries Face the Greatest Risks. To answer the second question first: it will be the countries with the highest external deficits, the highest inflation rates and the highest interest rates. In short, most vulnerable are the countries with the greatest excesses and imbalances. The old economists had a simple rule for the alternation of boom and recession. Simply, the length and severity of a recession depends partly on the magnitude of the preceding excesses and maladjustments and partly on the prevailing aggravations of monetary and credit conditions.

Where are the "inflationary excesses" in these countries many people ask in astonishment. Despite years of vigorous growth in their economies over the past years, haven't the central banks of all these countries managed to contain price inflation?

Credit Inflation Has Many Manifestations. Inflationary booms can breed very different kinds of side-effects and end-of-cycle symptoms. Yet they always have one and the same source: excessive credit (relative to available savings). The point to see here is that all these countries have credit excesses behind them that rival those in the 1970's. Only this time the worldwide impact on the prices of goods and services has been much more muted. Why? What is it that has made the difference?

The crucial difference between the two periods lies within the international enviroment. In the 1970's, other major countries were more obliging to U.S. inflationary policies, particularly Japan. This time, by contrast, the greater part of the world - mainly Japan and Germany with the whole of Continental Europe - pursued fiscal and monetary policies that were diametrically opposed to those of the United States, at least until 1987.

Cyclical Divergence: First Helpful Now Destructive. Instead of worldwide cyclical synchronization, as in the 1970's, there now has been cyclical divergence. Due to this policy shift, credit excesses in the over-expansive countries were largely diffused into exploding trade deficits thus supplanting the push of price inflation.

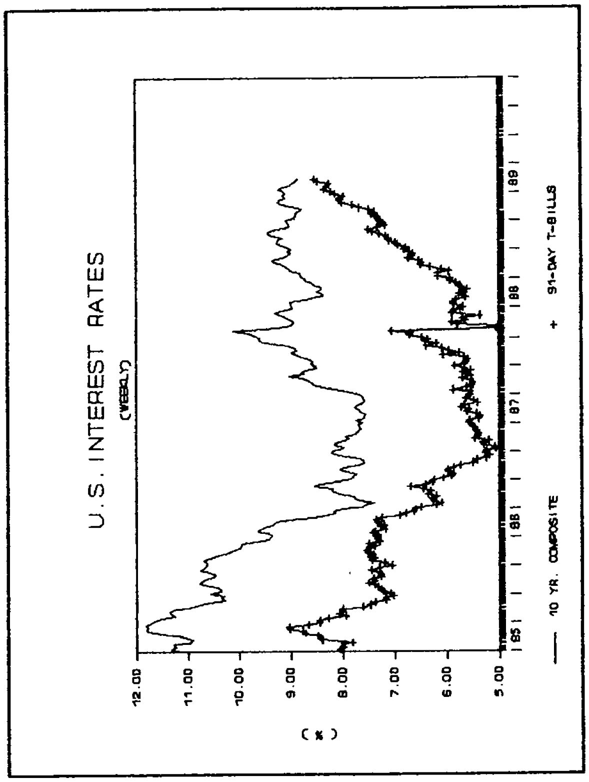
To get some measure of the relative magnitude of the excesses and imbalances created in these countries, we like to compare three factors: growth of credit, growth of GNP and cumulative current-acccount deficits. Here are the figures for the United States, all for the period between the year-ends of 1982 and 1988: increase in outstanding credit plus $4.3 billion; overall increase in real GNP plus $ 828 billion; and cumulative current-account deficit of $696 billion. Had this huge chunk of U.S. demand not been diverted into imports, where would U.S. inflation be today? Perhaps 10%, or 15%?

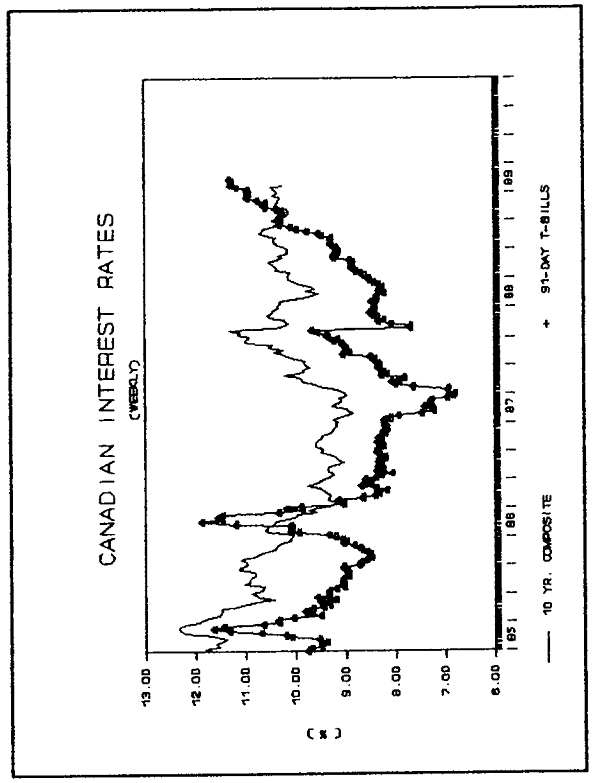
TIGHT MONEY SHOULD INEVITABLY MAKE ITSELF EVIDENT

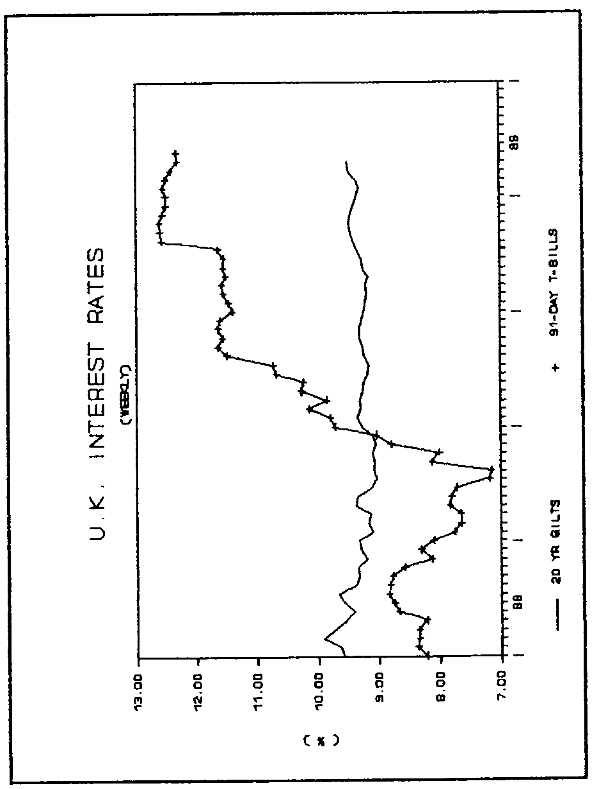
So much for the question of excesses. Now to the other question: How quickly and deeply will the monetary tightening that's been in place since the second quarter of last year, impact the different economies? The consensus view seems to be that economies in general are so robust that these measures have not yet appreciably affected them and that it will require still higher interest rates for a number of months. Quite a few complain that the current monetary tightening is far too gradual to fullfil its purpose.

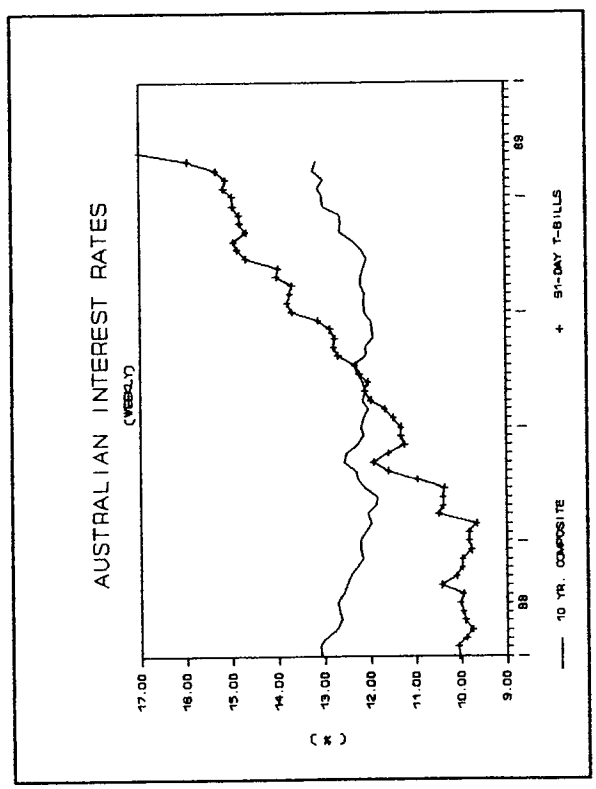
Let us first have a look those countries whose currencies are at the centre stage of the exchange markets. To what extent have the respective central banks had to push up their short-term interest rates? (Please see accompanying charts on page 10). All four charts, - covering the United States, Britain, Canada, and Australia - have one remarkable and unusual feature in common. All countries sport a sharp rise in short-term interest rates while long rates remained stable. In most, the result is the infamous inverted yield curve.

A Bizarre Attitude: Exchange Markets Chase Deficit Currencies.... Among the six countries with the highest short-term interest rates three stand out: Australia at 16%, Britain 13% and Canada with 11.3%. That compares with U.S. short-term rates a little above 8.5%. As a result, all these high-yielding currencies have appreciated against the low-yielding hard currencies. Though Britain has the second-highest short-term interest rates, after Australia, the British pound has been the weakest of the lot.


U.S. INTEREST RATES
(WEEKLY)
(%)
10 YR. COMPOSITE
+ 91-DAY T-BILLS


CANADIAN INTEREST RATES
(WEEKLY)
(%)
10 YR. COMPOSITE
+ 91-DAY T-BILLS


U.K. INTEREST RATES
(WEEKLY)
(%)
20 YR GILTS
+ 91-DAY T-BILLS


AUSTRALIAN INTEREST RATES
(WEEKLY)
(%)
10 YR. COMPOSITE
+ 91-DAY T-BILLS

Just what is so attractive about these currencies? Fundamentally...absolutely nothing. Without exception their trade balances are worsening, particularly in real terms. But, for now, the rise in their exchange rates indicates that capital inflows exceed current-account financing requirements. In other words, deficits are actually being "over-financed" for the time being. That is the measure of the trading mentality that causes world capital flows to jump into fundamentally weak currencies with both feet. The reason is obvious: the single-minded pursuit of high interest rates relative to those of the hard-currency countries. For the time being, it is interest-rate differentials alone that prevail over fundamentals.

...Causing Hindrances to Trade Adjustments. Authorities in all these countries are obviously happy with the strength of their currencies. It helps to contain inflation and improves the terms of trade. But unfortunately, it aborts the necessary trade adjustment even though such an invidious trend may be temporarily masked by improving terms of trade.

Everywhere, this same net result is before our eyes. As rising interest rates pull up the exchange rate, the two together hit with a particular vengenance at exports and business investment. Instead of squeezing domestic spending, the slowdown initially comes from falling export and capital spending growth. Allowing for the usual contractive multiplier effects, incomes and domestic spending follow later.

WEAKER ECONOMIES WILL BURST THE EXCHANGE MARKET BUBBLE.

As we have always stressed, the timing of the dollar's return to a bear market trend will depend on how quickly and sharply the weakening U.S. economy forces the Fed to loosen its monetary reins. The same applies, of course, to all the other high-yielding currencies. More probably, though, these latter countries will take their first cue from the actions of the American Fed.

The dollars's new rise since early December has been underpinned by the expectations that further strong economic growth will require continued high, if not rising, interest rates. In addition, the dollar may have enjoyed some further background support from the expectation that President Bush will seriously attack the budget deficit.

A key factor, no doubt, is the assumption that the U.S. economy remains strong and may be gathering momentum. In the last letter, we sharply disputed this view. Presenting detailed statistical data on third-quarter GNP, we showed that the U.S. economy has been rapidly losing momentum from the demand side - including exports, capital spending and consumption. Yet the media continues to fabricate bullish stories on the face value of aggregated numbers that conceal the real underlying trends.

TABLE 2
UNITED STATES: GROSS NATIONAL PRODUCT
(Change from preceding period, Billions 1982 Dollars, Seasonally Adjusted at Annual Rates.)

	1987	1988	87-IV	88-I	88-II	88-III	88-IV
GNP	125.3	148	57.7	33.1	29.1	24.2	19.8
Personal Consumption	65.8	70.1	-13.5	28.1	19.2	24.8	18.1
Durable Goods	5.9	17.7	-18.9	13.5	9.5	-0.2	2.1
Non-Durable Goods	11.0	9.4	-1.4	2.2	0.9	10.9	4.2
Services	48.8	43.1	6.8	12.3	8.9	14.1	11.8
Fixed Investment	12.0	42.1	2.0	8.6	16.8	4.8	-4.6
Net Exports	8.6	29.8	4.7	17.0	16.4	-1.3	-6.8
Government Spending	19.7	1.0	9.7	-16.2	7.4	-10.3	17.4

Source:U.S. Dept. of Commerce, Bureau of Economic Analysis

AN EARLY REVIEW OF FOURTH QUARTER GNP REVEALS FURTHER WEAKNESS

What are some of the critical features of the advance fourth-quarter GNP report that all commentators have again either missed or ignored? (For a longer perspective on trends in the third quarter, we refer the reader to pages 3-10 of our previous issue). First, net exports deteriorated as export growth dramatically slowed and import growth again accelerated; second, business investment in plant and equipment actually declined by 2.8% after having risen 20% in the first half of 1988. In both components, the same trend is evident as in the third quarter, only now intensified and gathering momentum.

What about the consumption boom during the fourth quarter that caused such excitement in the capital markets? Spending on durable goods rose $2.1 billion, after falling $0.2 billion the previous quarter. (See Table 2). While up, it's little more than levels in the third quarter in any case. Was this so-called boom in retail sales found in non-durable goods? No. The growth rate for this category of spending fell sharply from a 5% annual rate to 1.9%.

Government Purchases the Only Saving grace. Given the absolute decline in net exports and business investment on the one hand, and a slowdown in total consumer spending from a 3.9% to a 2.8% annual

rate, real fourth-quarter GNP growth would have fallen to little over zero had it not been for one item - soaring government spending. Strikingly, that category of spending rose $17.4 billion as compared with total GNP growth of $19.8 billion accounting for 88% of the advance. The biggest single item lifting government spending figures were net purchases of farm products probably as result of drought-related stabilization payments to farmers.

But Economic Data Still Seems to be Misinterpreted. Actually, the economic facts of the fourth quarter are precisely the opposite of what the Fed's latest report from its 12 district banks indicated. This report prepared for use at its February 7-8th, 1989 policy meeting stated: "the national economy gained momentum in recent weeks as consumer spending strengthened, manufacturing activity continued to rise, and producers scheduled more investment in plant and equipment".

THE FED'S AGENDA MAY BE MISDIRECTED.

It is a fact that all post-war recessions have not been recognized until many months after the slump's onset. Each time, an apparently booming economy had abruptly and unexpectedly slowed down. This time nothing booms anymore in the United States, neither exports nor business investment and consumer spending. Contrary to the Fed "tan book" and contrary to markets' perception, these demand components are all sharply down. Worries about inflation grow mainly out of the recognition of high levels of confidence and high levels of employment and capacity utilization. In our view, the latter are the classical late-cycle phenomena, including the sharp decline in productivity and the resulting boost in labor unit costs.

We are convinced that the Fed, like the consensus, is over-estimating the resilience of the U.S. economy and underestimating the force of the monetary stringency. While the rise in interest rates may appear gradual, the monetary aggregates say that the tightening is sharp. The second important point is that this monetary tightness hits a weak and also vulnerable economy given the high debt levels and the fragility of the U.S. financial system. A severe recession is becoming a major risk.

THE INTERNATIONAL PURSUIT OF A "SOFT-LANDING". A HAPPY SEQUEL APPEARS UNLIKELY.

Hopes are riding high that the Federal Reserve - and equally the central banks of the other deficit countries - will be able to engineer a soft landing both in their economies and their currencies. Such a soft landing would require that any decline in domestic demand must promptly be offset by rising exports.

Indeed, that is what happened in 1987/88 when highly expansionary policies in the surplus countries - together with the lower dollar - produced the American export boom, an echo in capital investment

boom and together the strong U.S. economic recovery. But this time, exactly the opposite is occuring in every respect. Due to the huge capital flows mindlessly chasing interest-rate differentials, it is the surplus countries that now have the lower exchange rates and booming exports. Meanwhile, the deficit countries have the strong currencies and face sharply falling export growth. And to make it worse, the surplus countries are now responding to the weakness in their currencies with a progressive monetary tightening in order to restrain their domestic demand. Actually, what could go more wrong in the world economy?

Only One Major Question Left. How Will Markets React? In one respect, the questions are now fewer. No longer is it a matter of whether and when the U.S. economy will begin to slump. To us, both answers are already eminently clear. The major question that remains is when capital markets will awaken to this reality and revise the perception of economic robustness. The subsidiary question then is how the Fed and the markets will respond when the evidence of a recession finally becomes overwhelming.

It seems probable that the first reaction of the markets will be to rush into long-term bonds on the assumption that inflation will abate. The latter may well be true. Yet there are two snags that need to be taken into consideration: one, is the direction of the U.S. budget deficit for fiscal 1989. Currently the projection is that it will rise to $162 billion from $155 billion in fiscal 1988. But that projection assumes that rates on three-month Treasury bill will average 6.3% for 1989 - against currently 8.5% - and that GNP will grow 3.5%.

Even if one assumes a more modest slowdown than we now expect, the budget deficit could easily escalate to $200 billion and higher. None of these calculations have factored in any Government financial aid for the troubled Savings and Loan Association or a host of other pressing expenditure requirements such as the nuclear waste clean-up.

The second big risk for the U.S. bond markets - and the bond markets of the other deficit countries - is their dependence on continued high capital inflows. In October 1987, it was the sudden halt in capital inflows that caused U.S. stocks, non-government bonds and the dollar to plummet at one and the same time. Thus, while in the interim a weakening economy and the anticipation of monetary easing may give the financial markets a temporary boost, all these economies and their markets are heading into highly risky territory. Yes, as always, the timing is uncertain but the ingredients for great trouble are undoubtedly fast looming into place.

ONLY A SHORT TIME FOR A STRONG DOLLAR

In our view, the most worrisome implication of the huge external deficits is simply that these deficit-countries have lost control over their monetary and fiscal policies. Excessive dependence on capital inflows restricts their ability to battle a recession. And to make it worse for some of them, fiscal policy is equally constrained.

In the meantime, high interest rates are needed to attract the foreign funds that support the currencies and financial markets of these countries. As long as markets - though wrongly - regard the U.S. economy as buoyant, feeding expectation of higher interest rates, the dollar should be able to maintain its elevated status. The same applies to the other deficit currencies. But the rationale of the exchange markets is at strange odds with fundamental sequence.

After all, higher currencies impede the adjustment of trade flows and current-account deficits - a progression that these countries so direly need. Yet further, the cold and searing reality is this: everything is now taking place against a background where most countries are together trying to restrain their domestic demand.

To return to the U.S., inevitably, as soon as it becomes apparent that growth is rapidly slowing - which in our estimation will be by the second quarter at the very latest - cyclical and monetary support for the dollar will quickly evaporate. With present developments in the current account and budget deficit proving grossly disappointing, the dollar will return to its long-term bear market with ferocious vigor.

CONCLUSIONS

After many months of rising interest rates and exchange rates, the overheated economies of the deficit countries are all losing momentum, some rapidly. But the trouble is that the major part of the slowdown comes from the wrong side: from exports. By contrast, economic growth in Europe and the ASEAN countries remains rather strong and well balanced. Yet, their growth is moderating. The two great surprises in 1989 may well be economic weakness in the United States and economic strength in Europe.

From this point of view, the international interest rate cycle should be near its peak. Everywhere, the financial markets may react to this with relief, but in the longer run, the fate of long-term interest rates will depend on the currencies. All the deficit countries owe the recent stability of their bond markets to the huge capital inflows. If these flows are interrupted, their credit crunch begins.

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